AN INTRODUCTION TO CORPORATE INSOLVENCY LAW

Hamish Anderson[1]

Abstract

English law provides three forms of insolvency proceeding for companies: liquidation, administration and company voluntary arrangements. This paper begins by examining the nature and purpose of insolvency law, the concepts of insolvency and insolvency proceedings, how insolvency practice is regulated and the role of the court. It then considers the sources of the law before describing the distinguishing characteristics of liquidation, administration and company voluntary arrangements. Finally, it deals with the sanctions for malpractice, transaction avoidance and cross-border insolvency.

Keywords: insolvency, liquidation, administration, company voluntary arrangement, office-holder, wrongful trading, fraudulent trading, director disqualification, transaction avoidance

Introduction

This paper is a high level introduction to corporate insolvency law for students of company law. Despite that being the context in which this paper is presented, it is wrong to regard insolvency law, even corporate insolvency law, as merely a branch of company law.

Insolvency law pre-dates company law by several centuries. The first insolvency legislation was passed in 1542, during the reign of Henry VIII.[2] That was an Act dealing with the insolvency of individuals whereas modern company law and its attendant insolvency rules are generally understood to derive from the Companies Act 1862. Recognisable traces of the insolvency provisions of the 1862 Act survive to this day in the Insolvency Act 1986.

---

[1] Partner, Norton Rose Fulbright LLP, London. Visiting Professor, Nottingham Law School, Nottingham Trent University. Visiting Fellow, Centre for Insolvency Law and Policy, Kingston University. Chairman, City of London Law Society Insolvency Committee. October 2015. (This paper was written as a seminar paper for the company law module of Plymouth University's LL.B course.)
[2] 34 and 35 Hen 8 c4: *An act against such persons as do make bankrupts.*

One consequence of that historical development is that rules and principles deriving from personal insolvency law also form part of corporate insolvency law. The subject matters of personal and corporate insolvency proceedings differ in the most obvious way but the aims of the law and the tools which the law offers are comparable in most respects but one. That is that personal insolvency law must take account of the fact that the debtor survives his or her financial misfortunes whereas a company can, and in appropriate circumstances will, be dissolved.

This paper omits detail in the interests of explaining the subject as a whole. For the same reason, it does not examine the many current questions of difficulty. As regards those questions, suffice it to say that even a cursory review of specialist company law reports will demonstrate the extent to which insolvency cases are a major part of the business of the Companies Court (insolvency accounts for more than a third of its caseload despite the concurrent jurisdiction of the county courts). The Court of Appeal is routinely delivering judgments in insolvency cases and, since the Supreme Court replaced the House of Lords on 1 October 2009, it or its alter ego the Privy Council have ruled in a series of important cases. Insolvency law is very far from being in a settled state and, in particular, may be said to be on the cutting edge of private international law.

1 The Function of Insolvency Law

Why have insolvency law? The simple answer to that question is that credit is indispensable in a modern free market economy and credit brings with it the possibility of default. The prospect of default necessitates rules to deal with it. Quite apart from borrowing money, goods and services are bought on terms that provide for payment after delivery. That is the extension of credit to the buyer. If pre-payment is required, it is the buyer who extends credit to the seller and so on. The extension of credit in whatever form and whether in large or small amounts, creates a need for the law to provide remedies to deal with default. The ordinary remedies are private remedies; the creditor obtains and enforces a judgment for his private benefit but sometimes the debtor cannot pay because his liabilities are greater than his means. Insolvency law then provides the method by which the remaining assets are administered for the benefit of all the creditors, replacing private competition between different creditors with an orderly distribution to all in so far as there are assets to support it. Thus throughout history societies with laws have had insolvency laws; Roman law included typically developed provisions dealing with insolvency. The existence of insolvency laws as part of the general body of laws is, and always has been, the norm.

There are, however, some examples of jurisdictions in which such laws are not much used or which have managed without any insolvency law. Some continue to do so. The reasons, in so far as they are apparent, vary. The most obvious examples of jurisdictions where existing insolvency laws were repealed or fell into disuse were the jurisdictions which together formed the former Soviet Union. The duality of state ownership and the repression of private enterprise made insolvency law redundant (although there continued to be mechanisms for enforcing the payment of debts by individuals). Privatisation and accessing the international capital markets has subsequently required the re-introduction of insolvency laws. Something similar has taken place in China following the end of the Maoist era. These are examples of jurisdictions which managed without insolvency laws during a period of their history; the explanation being that there was no market economy at the time. The collapse of the Tiger economies in South East Asia at the end of the 20th century afforded examples of jurisdictions with insolvency laws which, although ostensibly fit for purpose, were not, in practice, much used. There are two obvious reasons why insolvency procedures may be under-utilised. The first is cultural. It may simply be the case that the society which is served by the law finds other ways of resolving insolvency problems – for example there may be a strong sense of obligation that burdens not only the debtor but also underlying or related interests. The second possible reason for not using such insolvency laws as may exist is unattractive but realistic. No system of law is of much use unless it is supported by a court system which is both efficient and free from corruption. Sadly, there remain many countries in which neither is true.

There also isolated examples of jurisdictions which appear to continue to manage without any insolvency laws. Liberia and the Marshall Islands, both of which are American common law jurisdictions notable for their shipping registries, are examples. Neither are major trading nations and their respective populations are small - very small in the case of the Marshall Islands. It may be that the fact that their principal exposure to international finance and credit is through shipping and there are effective laws for mortgaging ships in those jurisdictions is enough.

Throughout the world, the World Bank, the International Monetary Fund and UNCITRAL[3] are actively promoting law reform programmes, sometimes as part of the price of financial support, and a long-term trend towards convergence is underway. The usual question, in an international context, is not whether there are insolvency laws but rather how far the laws conform to modern standards.

[3] The United Nations Commission on International Trade Law.

The reliance of modern society upon credit to facilitate commercial activity may explain the need for insolvency law but it does not explain how insolvency law addresses that need. To put this another way, insolvency law may be an indispensable part of our commercial law but it does much more than regulate the outcome of transactions where the counterparty is unable to discharge its obligations. In English law, it is possible to identify a number of different objectives but it is convenient to start with an economic perspective.

A highly influential economic view of the role of insolvency law is that it is replicates a hypothetical bargain between creditors which they would have reached if they had negotiated a solution in advance of their problems with the debtor and under which they would recognise the need for individual enforcement action to be stayed for the common good.[4] The law is designed to facilitate the outcome which a sole owner of the enterprise would have decided was in his best interests but to deliver that outcome for the benefit of the company and its creditors as a whole. Since a sole owner would use assets in the way that was most economically efficient, the result is to deliver the best returns for creditors. Rules which deliver the best returns for creditors promote the extension of credit.[5] A refinement of this approach identifies the role of insolvency law in ensuring that capital in the economy is put where it will be best used.[6]

Just as there is a need for insolvency process which produces a just result as between competing creditors, so too there is a societal interest in having procedures available which prevent a disorderly collapse. Problems with financial institutions conveniently illustrate two issues (neither of which is necessarily confined to that commercial sector). First, insolvency can present a risk of systemic failure (the domino effect). The defaults resulting from the insolvency of one institution can bring down others and threaten the survival of the market as a whole. (Another, more prosaic, example of systemic risk is where an insolvent company has a prominent market position, which could be national or merely local, so that its failure will lead to the insolvency of its suppliers and other aligned businesses such as sales outlets and franchises.) Secondly, there is the problem of companies being 'too big to fail' thus

[4] The work of Thomas Jackson stands out in this connection. For an early example, see T Jackson, 'Bankruptcy, Non-Bankruptcy Entitlements and the Creditors' Bargain' (1982) 91 *Yale LJ* 857.
[5] A useful review of empirical evidence in this respect is provided in A Menezes, 'Debt Resolution and Business Exit: https://www.wbginvestmentclimate.org/advisory-services/regulatory-simplification/debt-resolution-and-business-exit/upload/VIEWPOINT_343_Debt_Resolution.pdf.
[6] See further, KM Ayotte and D Skeel, 'Bankruptcy as a Liquidity Provider' 80 *U Chi L Rev* 1557 (2013); Jackson, Thomas H and Skeel, David A Jnr, 'Bankruptcy and Economic Recovery' (2013). *Faculty Scholarship*. Paper 476. http://scholarship.law.upenn.edu/faculty_scholarship/476; Paterson, Sarah, Rethinking the Role of the Law of Corporate Distress in the Twenty-First Century (November 18, 2014). LSE Legal Studies Working Paper No. 27/2014. Available at SSRN: http://ssrn.com.abstract=2526677 or http://dx.doi.org/10.2139/ssrn.2526677.

requiring rescue at the taxpayers' expense – the privatisation of profit coupled with socialisation of loss. Society has a very clear interest in its laws preventing any repetition of expensive rescues which followed the financial crash of 2008 and extensive new measures are being enacted in respect of the insolvency of financial institutions with precisely that end in view.

A rather different societal interest arises out of the privatisation policies of the late 20th century which resulted in previously state-owned utilities and other monopoly suppliers being exposed to the risk of failure. In those cases, the societal interest lies in the maintenance of essential supplies which has led to the proliferation of special procedures under which the interests of creditors are subordinated to the wider public interest.

These are all macro-economic considerations but not all the objectives of insolvency law reflect economic priorities – or at least not directly. Bankruptcy has lost some of its stigma but it remains a core objective of insolvency law to promote commercial prudence – so called 'moral hazard' and the imperative of discharging obligations as fully as circumstances permit. There is rigour attached to this aspiration in that English insolvency law includes provisions for the causes of insolvency to be investigated and reported upon. These are backed by other provisions designed to deter various forms of malpractice and, where deterrence has been ineffective, imposing sanctions.

At its most granular level, insolvency law also provides the means by which a failing company can address its problems in a timely manner and obtain relief from immediate creditor pressure (including individual enforcements), thereby enabling value to be realised in an orderly manner and distributed fairly amongst all the creditors. Optimal realisation of value in the case of a business failure will usually mean the disposal of the enterprise assets as a going concern. However, in an appropriate case, insolvency law also provides for the rescue and rehabilitation of the debtor ie the survival of the company itself. Indeed, restructuring is increasingly the focus of insolvency practice.

2 Insolvency and Insolvency Proceedings

Insolvency and insolvency proceedings are not the same thing. Insolvency is a financial state of affairs; insolvency proceedings are the means by which insolvency law addresses the issues resulting from that condition, provided, and this is an important proviso, that insolvency law is engaged. Not every company that experiences insolvency becomes the subject of insolvency proceedings. It is probably no exaggeration to say that a majority of start-ups are insolvent at the outset because their start-up costs exceed their initial capital

and the realisable value of the assets in which they have invested, and they are yet to receive any in-flow of funds derived from successful trading. There is no impropriety in this provided that their directors honestly and reasonably believe that the company will discharge its liabilities as they fall due. Other more established companies fall on hard times yet recover through the forbearance of their creditors or, in more severe cases, consensual restructuring of their liabilities without recourse to any proceedings.

What then is insolvency? This is an important question because insolvency is the trigger for many of the rights of both debtors and creditors in relation to insolvency proceedings. The term is not defined for the purposes of the Insolvency Act 1986 which refers instead to 'inability to pay debts'. There are two tests of inability to pay debts: the first being a cash-flow or liquidity test of inability to pay debts as they fall due and the second being a balance sheet test of liabilities (taking into account also contingent and prospective liabilities) exceeding assets. These are free-standing tests either of which is sufficient to establish insolvency although, in any given case, both may be found to be satisfied. It might be thought that both tests would turn on the state of the company's affairs at the precise time when solvency had to be determined but that is not so. As interpreted by the courts, neither test is satisfied simply by a contemporaneous snapshot; it is necessary to look into the future. The case of a company which is already in default of some undisputed payment obligations is straightforward but the case of a company which may default in the future is much less so. The cash-flow test becomes highly speculative as soon as it begins to depend upon predictions of future liquidity. Similarly, the balance sheet test is not about whether liabilities which have not matured due for payment exceed the present value of assets but rather whether those liabilities will exceed the value of the assets when the time for payment comes.[7] This futurity blurs the distinction between the two tests and can make their practical application a question of some difficulty with the result sometimes turning upon the burden of proof (because it is for the person seeking to establish insolvency, or the person seeking to rebut a presumption of insolvency, to do so on a balance of probabilities).

The legal test of insolvency is not to be confused with the accounting test to be applied in determining whether a company's accounts should be prepared on a going concern basis. The accounting test is directed to whether a company will be able to discharge its liabilities as they fall due in the foreseeable future (which, in practice means a minimum period of 12

[7] *BNY Corporate Trustee Services Ltd v Eurosail-UK 2007-3BL plc* [2013] 1 WLR 1408 (SC).

months).[8] This is ostensibly similar to the legal cash-flow test but, for these purposes, directors are expected to take all available information about the future into account. That includes, for example, non-binding letters of comfort from parent companies and the prospects of further capitalisation – neither of which constitute assets. Accounts should only be prepared on a liquidation basis if management either intends to liquidate the company or to cease trading (or has no realistic alternative but to do so). There is therefore a mismatch between the legal and accounting tests which can be misleading.

Insolvency proceedings take different forms depending upon whether they are focused on liquidation or rehabilitation and vary considerably between different jurisdictions. It is therefore not appropriate to attempt a definition of insolvency proceedings which could claim any universal application. The term is not a term of art; it refers instead to something more accurately described as a concept. With that qualification, it is possible to identify a series of signifiers the presence of which serve to indicate that the subject is an insolvency proceeding. That is not to say that all such signifiers will be present to an equal degree in every insolvency proceeding but rather that, if the procedure in question is broadly reflective of those signifiers as a whole, it is an insolvency procedure.

Probably the most important signifier is that the procedure should be collective, that is to say that it operates for the benefit of creditors generally (and can be distinguished, for example, from execution by individual judgment creditors, security enforcement by or on behalf of secured creditors and from regulatory intervention). This is consistent with the creditors' bargain theory of insolvency law; individual enforcement rights are replaced by rights of participation in a scheme for all the creditors. Lord Hoffmann summarised the collective nature of insolvency proceedings in *Cambridge Gas Transportation Corpn v Official Committee of Unsecured Creditors of Navigator Holdings plc*:[9]

> The purpose of bankruptcy proceedings, on the other hand, is not to determine or establish the existence of rights, but to provide a mechanism of collective execution against the property of the debtor by creditors whose rights are admitted or established…The important point is that bankruptcy, whether personal or corporate, is a collective proceeding to enforce rights and not to establish them.

---

[8] See further, paragraph 11 of Schedule 1 to each of the Small Companies and Groups (Accounts and Directors' Report) Regulations 2008 and the Large and Medium Sized Companies and Groups (Accounts and Reports) Regulations 2008); *International Standard on Auditing (UK and Ireland) 570: Going Concern* promulgated by the Financial Reporting Council in September 2013 and *International Accounting Standard 1*.

[9] [2007] 1 AC 508 (PC) at [14] and [15]. See also *Singularis Holdings Ltd v PricewaterhouseCoopers* [2015] 2 WLR 971 (PC) per Lord Sumption JSC at [11].

The proceeding is triggered by the actual or anticipated insolvency of the debtor and it is usually a public process. It results in a stay of individual creditor action. Conferring rights of participation in a collective scheme involves identification of the composition of the insolvent estate which becomes subject to those creditor rights. There is a cut-off date to determine the composition of the estate and another to determine the class of participating creditors (often the same date for both purposes). The cut-off date to identify the composition of the estate is supported by transaction avoidance rules to negative transactions which deplete the estate. Finally, liabilities incurred in the course of administering the estate are treated as expenses to be paid in priority to the claims of the pre-proceeding creditors.[10]

In English insolvency law there are two additional signifiers which may or may not be applicable to the insolvency laws of other jurisdictions. The first of these is that English law eschews debtor in possession procedures where the debtor company's own management remain in control of the process; English insolvency proceedings involve the appointment of an authorised insolvency practitioner to act as the office-holder and to administer the proceeding. The second is universalism. English procedures purport to address the assets and liabilities of the debtor worldwide. Foreign creditors have full rights of participation and the governing law of obligations does not affect their ranking.

The Insolvency Service: Insolvency Practitioners and Regulation

Insolvency practice is highly regulated. Regulation is achieved through a combination of government control and the licensing of insolvency practitioners by a small number of 'recognised professional bodies' which are then responsible for ensuring their respective practitioners' compliance with the law and practice standards. Within government, insolvency is primarily the responsibility of the Department of Business, Innovation & Skills which acts through the Insolvency Service, an executive agency of BIS.[11] The Insolvency Service (which deals with both corporate and personal insolvency) has a number of distinct strands of activity: policy, regulatory oversight, investigation and enforcement in connection with corporate malpractice (disqualification and prosecution), some case administration and paying statutory redundancy payments when employers default.

[10] This orthodox view of insolvency proceedings as a form of collective execution may now require reconsideration in the light of the special regimes referred to above where the principal purpose of the proceedings is the maintenance of essential public services.
[11] https://www.gov.uk/government/organisations/insolvency-service

Direct case administration by the Insolvency Service is undertaken through a network of 23 official receivers' offices serving different courts.[12] With limited exceptions, the appropriate official receiver becomes the first liquidator when a winding-up order is made and will thereafter continue to administer the estate if no private sector liquidator is appointed or if a vacancy arises. By this means, English law ensures that liquidation is always an available option notwithstanding any difficulty in securing the services of a private sector insolvency practitioner. If the circumstances of a case warrant it, the official receiver can be appointed as provisional liquidator before a winding-up order is made.

Insolvency practitioners are to be distinguished from office-holders. It is an offence to act as the office-holder in English insolvency proceedings (eg as a liquidator) when not qualified to do so. In order to be so qualified, an individual has, amongst other things, to have been authorised to act as an insolvency practitioner. To be an insolvency practitioner is therefore to be the holder of a qualification, not the holder of an office. There are approximately 1700 insolvency practitioners authorised pursuant to the Act. Most are authorised by one or other of the recognised professional bodies but a few are directly authorised by the Secretary of State.[13] An applicant for an insolvency licence must be a fit and proper person and have passed rigorous examinations set by the Joint Insolvency Examination Board. Active appointment taking insolvency practitioners are subject to monitoring to ensure that their cases are conducted in accordance with the law and good practice. The requirements of good practice are represented by a common Code of Ethics and a series of Statements of Insolvency Practice.[14] Breaches of the Code and the Statements of Insolvency Practice expose the errant insolvency practitioner to disciplinary action.

The Insolvency Service acts as the regulator of regulators.[15] In addition, the Service periodically issues 'Dear IP' letters to all insolvency practitioners which contain a mixture of alerts and indications of the Service's view on current issues. The consolidated Dear IP letters can be accessed through the Service's website.[16]

[12] Pursuant to Freedom of Information policies, the Insolvency Service makes its internal Technical Manual available online: https://www.insolvencydirect.bis.gov.uk/TechnicalManual/

[13] Authorisation by the Secretary of State is being phased out and will end during 2016.

[14] The Code of Ethics can be found on the Insolvency Service website: https://www.gov.uk/government/publications/insolvency-practitioner-code-of-ethics but the most convenient way to access the Statements of Insolvency Practice is via the website of R3, the trade association of insolvency practitioners: https://www.r3.org.uk/what-we-do/publications/professional/statements-of-insolvency-practice/e-and-w.

[15] See further ss137- 146 Small Business, Enterprise and Employment Act 2015.

[16] https://www.insolvencydirect.bis.gov.uk/insolvencyprofessionandlegislation/dearip/dearipindex.htm

Office-holders and the role of the court

In marked contrast to the usual approach of civil law jurisdictions, where insolvency proceedings result from court orders, English insolvency law includes 'out of court' procedures. Indeed, this has been a feature of English insolvency law ever since the Companies Act 1862. As will be explained in more detail later in this paper, English insolvency proceedings take one of three forms: liquidation, administration and company voluntary arrangements (within which there are some sub-divisions). Reference to Fig 1 entitled 'Company insolvency in England and Wales' which appears below shows that creditors' voluntary liquidation (a form of liquidation usually initiated by a shareholders' resolution) is currently by far the most common form of proceeding. A creditors' voluntary liquidation can be concluded without any involvement of the court. It is also the case that both administration and company voluntary arrangements can be conducted without any court hearings although both procedures require some filing at court. Only compulsory liquidation (winding up by order of the court) conforms to the civil law approach. The lack of court involvement can give rise to issues over the recognition of English insolvency proceedings in foreign jurisdictions.

The inclusion of out of court procedures in English insolvency law does not mean that the court has no role to play. Certain powers enjoyed by office-holders, for example the power to challenge antecedent transactions and examination powers, involve applications to the court for appropriate orders. More generally, the court exercises a supervisory jurisdiction in respect of all insolvency proceedings. Thus, for example, a liquidator appointed in a creditors' voluntary liquidation can apply to the court for directions and can be removed from office on the application of aggrieved creditors (who can also invoke the jurisdiction to obtain directions). Administration may or may not be started by an order of the court but, once in office, an administrator can also apply for directions and be removed. In addition, aggrieved members and creditors can challenge the administrator's conduct of the administration on the grounds of unfairness or even inefficiency and the court can make such order as it thinks appropriate. The approval of a company voluntary arrangement can be challenged in court on the grounds of either unfair prejudice or material irregularity and implementation of an approved arrangement by its supervisor can be challenged by any dissatisfied person. The court may therefore play a substantial role in all forms of insolvency proceedings but the extent of its involvement will naturally depend upon the facts of the case.

Reference has already been made to English insolvency law eschewing debtor in possession proceedings. That is the consequence of liquidation, administration and company voluntary arrangements all necessitating the appointment of an 'office-holder' – the

liquidator, administrator or, in the case of a voluntary arrangement, its supervisor – tasked with the conduct of the procedure. It sometimes suggested that a company voluntary arrangement is, on the contrary, a debtor in possession procedure because the proposal for a voluntary arrangement can emanate from the company's own directors, who will remain in office during the proceeding, but this overlooks the fact that the directors cannot supervise its implementation.

Is English Insolvency Law Codified?

There is no comprehensive statement of English insolvency law although the principal legislation for both personal and corporate insolvency law is now consolidated in the Insolvency Act 1986. The not infrequent references to the 'insolvency code' are therefore misleading. In context, they are generally found to mean either insolvency law as a whole or the ranking and priority of creditors which forms part of it.

Outside the 1986 Act (and its associated delegated legislation), important rules of law can be found in other acts of Parliament and in the rules of common law. The Third Parties (Rights Against Insurers) Act 1930 provides a good example of the former. At common law, the benefits of an insurance policy taken out by the debtor form part of the debtor's general estate which, in an insolvency proceeding, becomes part of the fund available for distribution amongst the creditors generally. Thus, if a debtor company causes an injury which is an insured risk, the general body of creditors would gain a windfall at the expense of the injured person. The perceived injustice of this was addressed by the 1930 Act by which the injured person is subrogated to the debtor's rights against its insurer. There is no reference to this important exception to *pari passu* distribution in the 1986 Act and there are numerous other examples of particular points on which it is necessary to refer to other legislation in order to ascertain the effect of the 'insolvency code'.

There are also common law rules affecting the application of provisions of the 1986 Act to which no reference is made in the legislation itself. The so called 'rule against double proof' is one important example. As will be explained, the process of distribution in liquidation and administration involves the submission of a claim by the creditor which is called a proof of debt. The rule against double proof precludes the admission of more than one proof in respect of what is, in substance, one liability. The most usual situation in which the rule is encountered arises out of guarantees. Where a debtor's liability has been guaranteed, the creditor has an ordinary claim against the debtor and the surety will also have an indemnity claim. The function of the rule is to prevent two dividends being paid out of the estate to the detriment of other creditors.

Equitable principles may be said to underlie much of the scheme for distribution in insolvent estates but that is now largely reflected in the legislation.[17] In other respects, equitable principles supplement or interact with the statutory rules – for example the equitable principles of estoppel, subrogation and marshalling and the concept of fiduciary duty as applied to insolvency office-holders. In short, there is no convenient single source of English insolvency law.

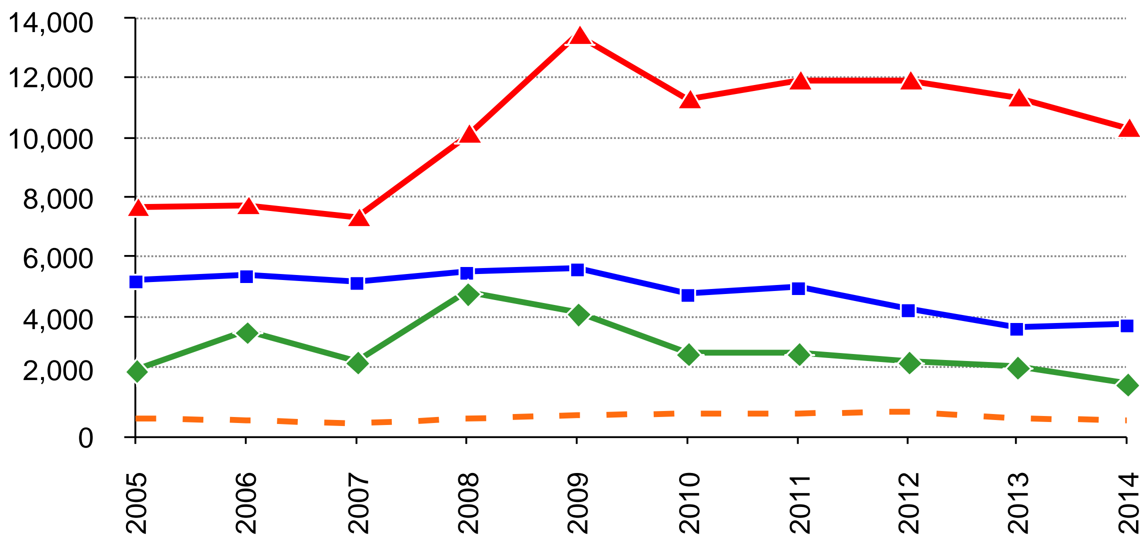
3 Corporate Insolvency Proceedings under English law

There are three forms of corporate insolvency proceeding in English law. Liquidation (whether compulsory or voluntary) is a terminal proceeding designed to realise the assets of the debtor company and distribute the realised value amongst creditors according to their respective priorities, following which the company is dissolved. Administration and company voluntary arrangements (not mutually exclusive and often used together) are two different forms of proceeding designed to preserve going concerns. The law relating to all these procedures, which are discussed in more detail in later sections of this paper, is principally to be found in the extensive provisions of the Insolvency Act 1986 and the Insolvency Rules 1986. (References to the 'Act' and the 'Rules' in the remainder of this paper are references to the Insolvency Act 1986 and the Insolvency Rules 1986.)

Some statistical information may help to put the following commentary in context. Fig 1 records the relative use of these procedures over the last 10 years:

[17] For historical background, see s170 Companies Act 1862.

Fig 1: Company insolvency in England and Wales



Key:

Creditors' voluntary liquidations

Compulsory liquidations

Administrations

Company voluntary arrangements

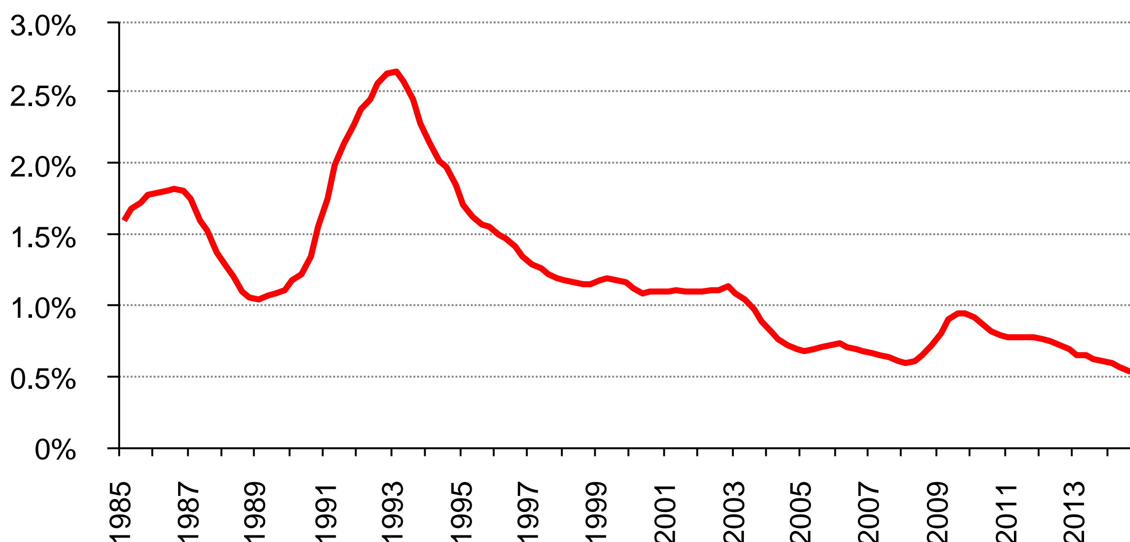
Source: Insolvency Service and Companies House

Liquidations (whether voluntary or compulsory, as to which see below) consistently outnumber administrations and voluntary arrangements. This is because liquidation is the only meaningful option for companies that have little or no realisable value. In cases where there is a viable business, albeit one burdened by excessive debt, administration is the preferred option. Unsurprisingly, the total annual number of insolvencies peaked in the aftermath of the financial crash of 2008. It is worth noting that the peak for administrations preceded that for liquidations, which is consistent with that procedure being used to preserve viable undertakings, with liquidation cases leading to break-ups taking longer to reach the point of no return.

Just as it may be helpful to explain the relative use of the procedures, so too it is worth noting the total number of insolvent liquidations expressed as a percentage of the number of active companies, because it remains the case that only a very small proportion of the active register is put into insolvent liquidation. Fig 2 demonstrates those percentages during the period 1985 to 2014:

Fig 2: Company liquidation rate in England and Wales

(rolling 12-month rate)



Key:

Liquidation rate (% of active register)

Source: Insolvency Service and Companies House.

This table does not take account of administrations and voluntary arrangements (except where they led to liquidation) because only liquidation results in the dissolution of a company and its removal from the active register. The peak recorded in 1993 marks the end of the 1990s recession. The percentage rate of attrition resulting from the more recent financial crash has been much lower. It is possible to advance a number of reasons why this should be so. First, borrowing costs have remained low resulting in a significant number of so-called ‘zombie companies’ trading on whilst lenders have been reluctant to recognise further losses for which additional provisioning would be required. Secondly, and more positively, creditors generally are now far more aware that insolvency proceedings should be viewed as a last resort and that there are often more constructive outcomes that can be achieved through forbearance and negotiation.

4 Liquidation

Liquidation can either result from a winding-up order made by the court, which is called a ‘compulsory liquidation’, or a shareholder resolution, which is called a ‘voluntary liquidation’. A voluntary liquidation is called a ‘members’ voluntary liquidation’ if the company is solvent or a ‘creditors’ voluntary liquidation’ if the company is insolvent. Members’ voluntary liquidations are also a procedure under the Insolvency Act 1986 and must be conducted by a liquidator who is an insolvency practitioner but are outside the scope of this paper.

The most important differences between compulsory liquidations and creditors' voluntary liquidations relate to the commencement of the proceedings and the appointment of the liquidator. Thereafter, although the applicable rules are to be found in different sections of the Act and Rules (for largely historic reasons) they are substantially to the same effect in terms of the functions, powers and duties of the liquidator. Directors who recognise that their company should be put into liquidation will usually prefer a creditors' voluntary liquidation (provided they can procure the necessary shareholder resolution) because it is quicker and cheaper to pass a resolution than apply for and obtain a winding-up order and because the shareholders (who in an SME will likely be the directors or their associates) have an opportunity to nominate the liquidator. The procedure requires a meeting of creditors to be convened within 14 days but it is usual to arrange for the creditors' meeting to take place on the same day as the members' resolution is passed. The directors are required to present the creditors' meeting with a statement of affairs and the creditors then have an opportunity to replace the members' nominated liquidator with another practitioner of their own choosing.

Creditors who cannot persuade an insolvent company to put itself into liquidation can only force the issue by means of a winding-up petition. The presentation of a petition can of itself cause irreparable harm to a company and the court will grant an injunction to restrain the presentation of a petition where there is reason to anticipate proceedings being wrongly commenced. The petitioning creditor must have a petition debt which is not genuinely disputed and must satisfy the court of the company's insolvency. The court does not hesitate to dismiss petitions based on disputed debts or to make costs orders against petitioners misusing the procedure. There is technically no minimum size of debt to support a petition but a creditor requires a minimum debt of £750 to be able to serve a formal statutory demand for payment such that continuing default will, without more, be treated as evidence of insolvency, and the court would be unlikely to make an order based only on a smaller debt. The making of a winding-up order remains a matter for the court's discretion but an order will only be refused in exceptional circumstances where jurisdiction and grounds have been established. In practice, a very significant proportion of all winding-up orders are made on the petition of HMRC based on unpaid tax liabilities.

On the making of a winding-up order, the official receiver becomes the liquidator and remains in office unless or until he is replaced by a private sector insolvency practitioner, usually by means of a resolution passed at a creditors' meeting. In a creditors' voluntary liquidation, the liquidator nominated by the members is in office from the passing of the resolution for his appointment but his powers are restricted until the creditors' meeting has taken place (at which he may be supplanted by the creditors' choice of another practitioner).

The appointment of a liquidator ends the directors' own powers to control the company's affairs and brings into effect a statutory trust over its assets for their realisation and distribution in accordance with the scheme of the legislation.[18] The court will, where necessary, issue anti-suit injunctions to prevent creditors who are amenable to its jurisdiction from taking action which interferes with the proper execution of the scheme – for example by seeking to attach assets of the company which are outside the jurisdiction.[19]

The liquidator's powers are provided by the Act. The powers are sufficiently wide to cover all normal methods of realising the value of the company's assets including the commencement of such proceedings against third parties as may be necessary for that purpose. The liquidator only has power to carry on the company's business so far as may be necessary for it to be wound up. In an exceptional case, that power might be used to complete a pending contract but, in most cases, the commencement of liquidation brings any continued trading to an abrupt halt.

The other side of the liquidator's functions is the distribution of the realised estate, net of the costs and expenses of the liquidation (which include the liquidator's remuneration), amongst the creditors. For this purpose, the liquidator will call for the submission of proofs of debt from the creditors. Secured creditors need only prove to the extent that their security is not sufficient to cover their claims but all creditors who wish to participate in the liquidator's distributions must submit proofs upon which the liquidator then adjudicates. A creditor who is aggrieved by the liquidator's decision on his proof can appeal to the court. After the payment of the expenses of the liquidation, the first ranking unsecured claims are those of the company's preferential creditors (principally a limited range of employee claims). The balance is then distributed *pari passu* amongst the ordinary unsecured creditors. If there is a surplus it is used to pay interest before anything is returned to the shareholders. This order of distribution is complicated by the subordination of floating charges to the claims of preferential creditors and to requirement that the liquidator make a 'prescribed part' of what would otherwise be paid to the holder of the floating charge available to the ordinary unsecured creditors. The prescribed part is a percentage of the floating charge realisations (after providing for the expenses and the preferential creditors) which is capped at £600,000. The result is that the floating charge holder will only be paid in full if the floating charge realisations are sufficient for that purpose, even after allowing for the preferential creditors and the prescribed part, or there is a surplus in the estate. The prescribed part was

---

[18] *Ayerst v C&K Construction Ltd* [1976] AC 167 (HL).
[19] *Stichting Shell Pensioenfonds v Krys* [2015] AC 616 (PC).

introduced by the Enterprise Act 2002 in an effort to reduce the number of liquidations in which the entire estate was taken by the secured and preferential creditors leaving nothing at all for unsecured creditors, which in turn caused creditor apathy and a lack of commercial confidence in the procedure. When the affairs of the company are fully wound up, or wound up as far as is practicable, the liquidator closes the liquidation and the company is dissolved.

5 Administration

Administration is a means to an end. In itself, it merely results in a temporary suspension of creditor remedies while the administrator pursues the statutory purpose of administration. That purpose is rescuing the company as a going concern, failing which, achieving a better result for creditors than would be likely in a liquidation, or, failing both of which, realising assets in order to make distributions to secured or preferential creditors.

Some features of administration can only properly be understood by reference to its background. Administration was introduced into English insolvency law by the Insolvency Act 1985, which was immediately consolidated into the 1986 Act. The procedure was a response to the perceived utility of Chapter 11 of the US Bankruptcy Code, which had been enacted a few years earlier as a business rescue procedure (but administration is markedly different in that Chapter 11 is a debtor in possession procedure). Before 1986 the principal means of preserving a viable business which was owned by an insolvent company was for the business to be sold as a going concern by a receiver. The receiver was appointed for that purpose by a secured creditor, usually a bank, which held security over all the assets and undertaking of the company through a combination of fixed and floating charges. Although such receiverships (called 'administrative receiverships' in the 1986 Act) in some ways resembled an insolvency proceeding, they were not a true insolvency proceeding because they were security enforcement for the exclusive benefit of a secured creditor. They were nonetheless perceived to be beneficial in saving businesses, but not the companies that owned the businesses, from liquidation. Administration was originally introduced in order to provide a means of enabling businesses to be sold as going concerns when there was no secured creditor which was able to appoint an administrative receiver. Administrative receivership and administration were mutually exclusive and secured creditors with the power to appoint administrative receivers were in a position to veto administration. This meant that administration was relatively little used in its early years. The position was dramatically changed by a series of amendments to the 1986 Act which resulted from the Enterprise Act 2002 and as part of which administrative receivership was outlawed in all but a few special cases. The underlying policy then being pursued was that administration should take over as the principal means of business rescue. Secured creditors who would

otherwise have been able to appoint an administrative receiver were compensated by being given power to appoint an administrator; the practical difference between the two forms of appointment being that an administrator is required to act in the interests of the creditors as a whole rather than in the particular interests of the appointing secured creditor. In the terminology of the new legislation, a secured creditor who would have had the power to appoint an administrative receiver is called the holder of a 'qualifying floating charge'.

Administrators can be appointed by the court or, out of court, by the holder of a qualifying floating charge, the company or its directors. The different procedures are all such that the qualifying floating charge holder's choice of administrator will usually prevail. The company must be insolvent or likely to become so unless the appointment is being made by the holder of a qualifying floating charge in which case the test is whether the security has become enforceable (which, in practice, is likely to mean much the same thing). The purpose of administration must also be reasonably likely to be achieved.

Administration triggers what is referred to in the legislation as a moratorium although it is not strictly speaking a moratorium because the company's debts remain payable despite the suspension of remedies for non-payment. The moratorium prevents all forms of proceedings against the company and its property, repossession of leased goods, forfeiture of leased premises and security enforcement without the consent of the administrator or the leave of the court. (There is an interim moratorium while the appointment of an administrator is pending.)

The administrator has very wide powers (far more extensive than those of a liquidator) to deal with the company's assets and undertaking, which enable him to carry on the company's business. The directors of the company remain in office but the composition of the board can be changed by the administrator and the board cannot exercise its management powers in any way which interferes with the exercise of the administrator's powers. Under the scheme of the legislation, the administrator is required to formulate his 'proposals' for achieving the purpose of administration and to put those proposals to the creditors for approval. In practice, this process is often pre-empted by what is called 'pre-packing'. Pre-packing occurs when the outcome of administration, often a disposal of the business, has been negotiated in advance and is implemented immediately upon the administrator being appointed. This has attractions for secured creditors in providing certainty as to the outcome and controlling costs but it is controversial amongst other creditors (and sometimes would be buyers) who are presented with a *fait accompli*. Pre-packing is most controversial where it entails a sale back to the company's own directors.

'Phoenixism' is repugnant to many ordinary creditors yet it is a fact of life that a company's own management are often in a position to make the best offer for the company's assets – particularly in cases where the survival of the business depends upon their own continued participation.[20] The Secretary of State has recently taken power to make regulations controlling pre-packing to connected persons but it is likely that the government will wait to see whether further self-regulation will be sufficient before deciding whether to exercise that power. The administrator can deal freely with floating charge assets and can apply to the court for an order to compel the sale of fixed charge assets (in which case the secured creditors receive the proceeds of sale). These powers enable the administrator to avoid the break-up of business assets because of fragmented interests.

Following further changes resulting from Enterprise Act amendments, the administrator can be authorised by the court to make distributions to creditors and rules on proof of debt modelled on those for liquidations apply. Administration ends automatically after 12 months unless extended. In the very unusual case of the company itself (as opposed to its business) being rescued as a going concern, the administration ends with the company being returned to its own management. In other cases, administration can be followed by compulsory or creditors' voluntary liquidation (the latter being initiated by the administrator sending notice to the registrar of companies instead of a shareholders' resolution) or, if the administrator thinks that there is nothing to be distributed to creditors, the company can be dissolved.

6 Company Voluntary Arrangements

Company voluntary arrangements, as is apparent from Fig 1, are the least used procedure under the Act. The procedure enables a proposal to be put to a company and its creditors (usually by its directors but possibly by a liquidator or administrator) for a composition in satisfaction of its debts or a scheme of arrangements of its affairs. The proposal must nominate an insolvency practitioner, the 'nominee', to act in relation to the implementation of the proposal if it is approved. If the proposal is being made by the directors, they must submit it to the nominee who must report to the court on whether there is a reasonable prospect of the arrangement being approved and implemented and meetings should be summoned to consider it. If he has reported that meetings should be summoned, he then

[20] See further: Graham Review into Pre-pack Administration, June 2014: https://www.gov.uk/government/publications/graham-review-into-pre-pack-administration; Statement of Insolvency Practice 16: https://www.r3.org.uk/media/documents/technical_library/SIPS/SIP%2016%20Version%203%20Nov%202015.pdf (effective from 1 November 2015) and para 60A of Sched B1 to the Act.

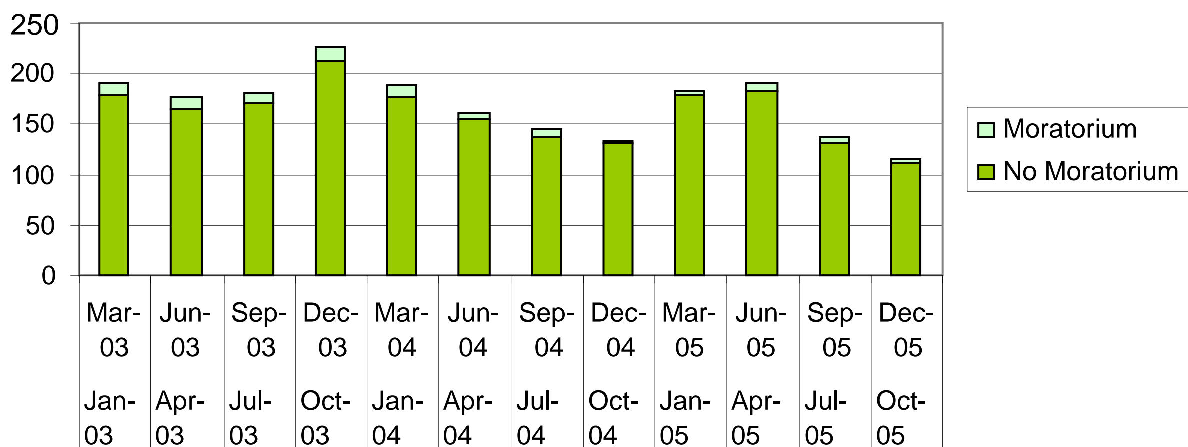
goes ahead and convenes the meetings unless the court directs otherwise. If the nominee is the liquidator or administrator, he proceeds straight to convening meetings.

Separate meetings of the company and its creditors then consider the proposal, which they can approve with or without modifications but an arrangement cannot affect the rights of secured or preferential creditors without their consent. If the decisions of the meetings are different, that of the creditors' meeting prevails unless an aggrieved member makes a successful application to the court for a contrary ruling.

Under an approved arrangement, the nominee becomes the 'supervisor' of the arrangement which binds all the creditors who were entitled to vote at the creditors' meeting (or would have been if they had had notice of it). The approval of an arrangement is open to challenge on the grounds of either unfair prejudice or material irregularity within a period of 28 days following reports of the outcome of the meetings being given to the court. If issues arise during the course of the arrangement being implemented, the supervisor can apply for directions and interested person who are dissatisfied with his conduct of the arrangement can seek appropriate orders.

The question naturally arises as to why this procedure is so little used. As originally introduced by the Act, the procedure made no provision for a stay whilst a proposal was being approved. This perceived deficiency was addressed by the Insolvency Act 2000 which amended the Act so as to make an optional variation of the procedure available to small companies which includes a stay modelled on that in an administration. These changes only took effect on 1 January 2003 and were rendered significantly less important by the introduction of out of court administrator appointments on 15 September 2003. Fig 3 shows the very limited use of the new procedure during the first two years after it was introduced:

Fig 3: CVAs: Moratorium v No Moratorium



Source: Insolvency Service and Companies House.

No later statistics are available but anecdotal evidence is consistently to the effect that the procedure is rarely used. One contributing factor may be that the nominee is required to undertake significant responsibilities in satisfying himself as to the funding of the company and monitoring its activities whilst it continues to trade under its own management.

Company voluntary arrangements were intended to offer a more flexible and informal alternative to schemes of arrangement under the Companies Acts but such schemes remain the preferred restructuring tool for large and larger mid-cap companies even though there too there is no stay. This may be because such restructurings are likely to be directed to effecting arrangements between a company and its financial creditors, leaving trade creditors being paid in full in the ordinary course of business. In such circumstances there may well be no commercial need for a stay. Other reasons for preferring Companies Act schemes may be the certainty resulting from the court order approving a scheme (in contrast to the post-approval challenge period in a company voluntary arrangement) and issues of recognition in foreign jurisdictions. In the case of smaller companies, where a stay may be more important, there appears to be a clear preference for the certainty and office-holder control of administration.

7 Wrongful trading, Fraudulent Trading and Disqualification of Directors.

Both outright dishonesty and genuine misfortune are less common causes of insolvency than is sometimes supposed. Most insolvencies result from a degree of culpable mismanagement. Sanctions for malpractice are an important part of insolvency law – not least by serving as a deterrent. The Act makes various forms of fraudulent misconduct

criminal but the principal means by which insolvency law influences the conduct of the directors of companies which are experiencing financial difficulties are exposure to civil liability for wrongful trading, to both civil and criminal liability for fraudulent trading and the risks of disqualification proceedings.

It is popularly supposed that 'trading while insolvent' in itself attracts sanctions but that is not correct. The immediate consequence of actual or anticipated insolvency is that the directors of a company must act with regard to the interests of the creditors of the company. Even though trading whilst insolvent does not, of itself, involve any exposure to liability, it is nonetheless a high-risk situation in which the rules on fraudulent and wrongful trading come into play.

In the context of corporate insolvency law, fraudulent trading involves a hybrid approach to the misconduct. Fraudulent trading is said to occur when the business of a company is carried on with intent to defraud creditors or for any other fraudulent purpose. Under the Companies Act 2006, such conduct constitutes a criminal offence carrying a maximum sentence of ten years. Formal insolvency is irrelevant in this context, so the provision is more properly characterised as part of the general criminal law. On the other hand, if in the course of an administration or liquidation it appears that fraudulent trading has occurred, the office-holder can apply pursuant to the Insolvency Act for an order requiring persons who were knowingly parties to the fraudulent trading to make such contribution to the company's assets as the court thinks fit. There is therefore a criminal offence which is not insolvency related but which is coupled with a civil or compensatory provision which is only applicable in the event of insolvency proceedings.

The concept of fraudulent trading which involved both civil and criminal consequences was introduced by the Companies Act 1928 but has not been without problems. The courts have consistently refused to impose civil liability without proof of dishonesty and have imposed a strict standard of proof on office-holders seeking to make recoveries from errant directors whose continued trading activities had inflicted losses on creditors. That eventually led to the introduction of liability for wrongful trading. Like fraudulent trading, wrongful trading is a statutory form of liability under the Act which is only actionable by administrators and liquidators (or their assignees) but, instead of a test of dishonesty, it articulates a tortious standard of care. There is no definition of wrongful trading as such; instead, under that heading, the Act prescribes circumstances in which directors (and shadow directors) can be liable to contribute to a company's assets. This involves proof by the office-holder of the directors knowing, or being in a position where they ought to have known, in advance of

liquidation, that an insolvent administration or liquidation was inevitable. The position of each director is considered separately. The test of what a director actually knew is, of course, wholly subjective but, for the purposes of deciding what a director ought to have known, the test is partly subjective and partly objective. It has regard not only to the general knowledge, skill and experience of the director in question but also that which can be expected of a person with the functions entrusted to that director.

Where wrongful trading is established on the part of directors, the court has a discretionary power to order them to contribute to the company's assets unless, by way of defence, they can establish that after insolvency proceedings could be seen to have been inevitable, they took every step with a view to minimising loss to creditors. An award for wrongful trading should be the amount by which the company's assets have been depleted by the conduct in question and the rule of thumb is to measure the increase in the deficiency during the period between the first perception of inevitable proceedings and the eventual commencement of those proceedings.

It might therefore be thought that, following the introduction of wrongful trading, civil liability for fraudulent trading became redundant, but this is not so. In this connection it is important to appreciate first that the focus of the two remedies is fundamentally different. Fraudulent trading is not merely a particularly aggravated form of wrongful trading. It is concerned with the propriety of incurring new liabilities. As interpreted by the courts, the test is whether there was a genuine belief in a reasonable prospect of those liabilities being discharged as they fell due. Wrongful trading is concerned with the reasonable prospect of a company avoiding insolvency proceedings. This is focused on the likely outcome for all creditors. Given the different nature of the tests it is possible, albeit unlikely, for fraudulent trading to be established without wrongful trading, for example in a case where directors were justified in thinking that a company could still avoid proceedings through some form of arrangement with its creditors but caused it to incur new liabilities in the meantime which they knew the company would be unable to discharge as they fell due (robbing Peter to pay Paul). That said it is more likely that the remedies will overlap in any case where fraudulent trading has occurred and an office-holder who can make out both fraudulent and wrongful trading will inevitably prefer to address the lower standard of proof demanded in respect of the latter.

In some respects, however, the scope of fraudulent trading is wider and so it retains a useful place in the office-holder's armoury. First, only directors (or shadow directors) can be liable for wrongful trading but fraudulent trading claims can be brought against any person who is 'knowingly a party to' the carrying on of the company's business with intent to defraud. In

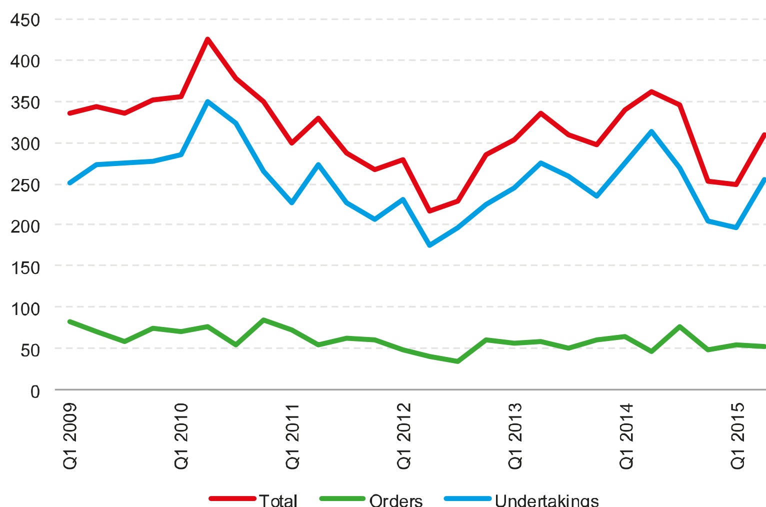
practice, the persons most likely to be party to fraudulent trading are the directors but the remedy is not so restricted and, for example, a creditor could incur liability by accepting money which it knows to have been procured by carrying on the business for the very purpose of making the payment. Secondly, the fraud does not have to be directed at the company itself or even the company's own creditors. If the business of the company is being conducted with intent to defraud the creditors of another person or for any other fraudulent purpose (for example, tax evasion) the rules apply.

Alongside exposure to civil and criminal liability for malpractice, company directors (and those instructing them) risk disqualification. This is primarily a prophylactic jurisdiction designed to protect the public from future misconduct but it has very recently been amended to make provision for compensation to be paid in appropriate cases. The concept of disqualification in the absence of any requirement for qualification is, at first sight, unusual but its origins also go back to the Companies Act 1928. In practice the most used ground for disqualifying directors is unfitness, which was introduced by the Insolvency Act 1985 and shortly afterwards consolidated with other disqualification provisions in the Company Directors Disqualification Act 1986. The jurisdiction is now very well established and operates as a powerful deterrent. This is the more so because the costs of resisting disqualification proceedings (brought with the resources of the state) are considerable, legal aid is not generally available and an unsuccessful defence will usually result in the director having an order for costs made against him .

Disqualification cases involve a minute examination of the director's conduct. Following changes resulting from the Insolvency Act 2000, the Secretary of State has been able to accept disqualification undertakings in cases of unfitness in lieu of seeking orders – a procedure which has attractions for both sides even though it remains questionable whether this system of plea bargaining between parties of such unequal strength is entirely just. Fig 4 shows that a majority of cases are now disposed of by undertakings:

Fig 4: Director Disqualification Orders and Undertakings

(quarterly data, Great Britain)

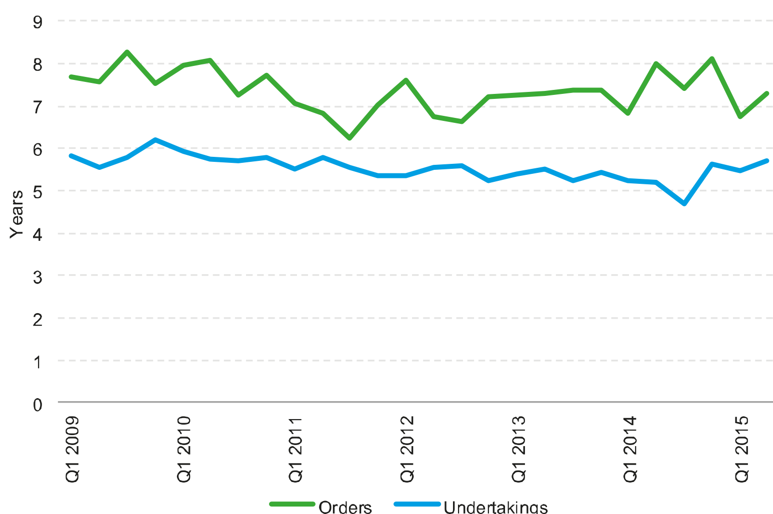


Source: Insolvency Service

The disqualification jurisdiction is supported by reporting obligations of office-holders on the basis of which the Insolvency Service identifies cases which warrant further investigation. Ultimately, it is the responsibility of the Service to bring disqualification proceedings or demand undertakings. (The Service trumpets its successes on Twitter: #DodgyDirectors.) If unfitness is established, disqualification is mandatory for a period of between two and fifteen years (with about 10% of cases falling into the top bracket resulting in disqualification for more than 10 years). Fig 5 demonstrates that average disqualifications are for between 5 and 8 years:

Fig 5: Average Length of Director Disqualification Orders and Undertakings

(quarterly data, years, Great Britain)



Source: Insolvency Service

The average disqualification resulting from undertakings is lower than that resulting from orders. The Insolvency Service states that this is in recognition of saving the costs of proceedings and achieving earlier protection of the public but it, presumably, also reflects the fact that a bargain has been struck. Flouting disqualification can result in imprisonment.

It remains to be seen how the new provisions for compensation orders and undertakings will operate in practice. Compensation can be ordered, or an undertaking accepted, where a person is disqualified as a result of conduct which has caused loss to the creditors of an insolvent company. There is no prescribed limit to the amount of compensation that may be required but it will, presumably, be limited by reference to the amount of the loss caused and mitigated by the usual discretionary considerations. One striking distinction between compensation payable pursuant to the disqualification regime and amounts payable in respect of fraudulent and wrongful trading is that disqualification compensation can be hypothecated, that is to say that it can be made payable to particular creditors or classes of creditors.

8 Contracting-out and *pari passu* Distribution

It is a fundamental principle of English insolvency law that agreements which purport to disapply its rules are ineffective. The issue arose in *British Eagle International Air Lines Ltd v Compagnie Nationale Air France* where the liquidator of British Eagle successfully challenged clearing house arrangements between members of IATA under which monthly balances as between members were replaced by a single net sum due to or from IATA. Lord Cross said:[21]

> …what the respondents are saying here is that the parties to the 'clearing house' arrangements by agreeing that simple contract debts are to be satisfied in a particular way have succeeded in 'contracting out' of the provisions contained in [the relevant legislation then in force] for the payment of unsecured debts 'pari passu.' In such a context it is to my mind irrelevant that the parties to the 'clearing house' arrangements had good business reasons for entering into them and did not direct their minds to the question how the arrangements might be affected by the insolvency of one or more of he parties. Such a 'contracting out' must, to my mind, be contrary to public policy.

The principle is a true one but the linkage with *pari passu* distribution in the foregoing passage from *British Eagle* is confusing because there are many exceptions to *pari passu* distribution itself – some of which arise out of consensual dealings whereby counterparties creditors legitimately seek to protect themselves from ranking alongside other creditors in

[21] [1975] 1 WLR 758 (HL) at 780G.

the event of an insolvency. The first, and commonest of these techniques, is the taking of security. Although there is statutory subordination of floating charges to the claims of preferential creditors and the prescribed part, property taken by way of security does not form part of the debtor's estate which is available to the debtor's general body of unsecured creditors. Rather it is the equity of redemption or excess value over the secured indebtedness which forms part of the estate. Other examples are retention of title in the context of the sale of goods, and trust assets. The exclusion of trust property from the debtor's estate has enabled lenders to structure advances in such a way that the money must be returned if not used for the specific purpose for which it was lent.[22]

The distinguishing feature of these arrangements is that they create or preserve third party proprietary rights. Subject to certain rules on transaction avoidance which are the subject of the next section of this paper, English insolvency law respects pre-proceeding proprietary rights with the result that the holders of those rights do not have to share *pari passu* with unsecured creditors (except as regards as deficiency). Another departure from true *pari passu* sharing amongst creditors results from set-off. In liquidation and administration, insolvency set-off is mandatory and self-executing with the result that only a net balance is due one way or the other between the insolvent estate and the counterparty.[23]

Reference has already been made to preferential creditors but there are also some claims which are deferred by statute (and there some other significant exceptions to the ordinary rules in the case of financial markets and collateral). However, none of these variations and exceptions to *pari passu* distribution detract from the fundamental principle that it is not possible to contract out of the insolvency rules whatever they may be; rather instead, they are merely examples of where the insolvency rules do not provide for *pari passu* distribution. To that extent, the statement of principle quoted from *British Eagle* needs to be qualified.

9 Transaction Avoidance

Insolvency law without any rules on transaction avoidance is conceivable but unlikely to be found in practice. Rules, which differ in detail but which serve broadly similar purposes, are a feature of all developed legal systems. In terms of English legislation, laws on transaction avoidance came earlier than our first insolvency statute. Thus an enactment in 1376, during

---

[22] *Barclays Bank Ltd v Quistclose Investments Ltd* [1970] AC 567 (HL).
[23] *National Westminster Bank Ltd v Halesowen Presswork and Assemblies Ltd* [1972] AC 785 (HL); *Stein v Blake* [1996] AC 243 (HL).

the reign of Edward III, provided that property given by debtors to friendly third parties remained available to be taken in execution by the debtor's creditors.[24]

For the purposes of this paper, insolvency transaction avoidance covers all rules whereby consensual dealings which would otherwise be binding on a company and its counterparty may be rendered ineffective, set aside or adjusted by reason of factors which include the actual or anticipated insolvency of the company. Thus insolvency transaction avoidance is distinguishable from, for example, provisions of company law regulating transactions by and with directors and from the rules of general law whereby transactions can be set aside on the grounds of mistake (although such rules may, in a given case, also be in play). Taken as a whole, the transaction avoidance rules amount to a significant incursion on the principle that English insolvency law respects pre-proceeding proprietary rights.

The concept of an insolvent estate which is the subject of collective execution necessitates the identification of a cut-off date (or dates) by reference to which the composition of the estate will be identified. Whatever dates are chosen run the risk of creating anomalies. The principal purpose of most transaction avoidance rules is to ameliorate that potential for injustice and thereby promote equal treatment of creditors.

Some rules are concerned with retaining property in the estate. Thus unauthorised post-commencement dispositions by the company are invalidated as are unregistered charges, and late floating charges are only good security for new money. Liens on books and records are rendered unenforceable. There also two rules which flow from the principle that is not permissible to contract out of the statutory scheme: first, the *pari passu* rule which has already been discussed and, secondly, the anti-deprivation rule which renders void agreements which purport to remove an asset from the insolvent estate in the event of insolvency proceedings.[25]

Some other rules are concerned with restoring property to the estate which has been the subject of pre-proceeding dispositions. When a debtor company enters into some form of disposition that gives a particular creditor an advantage over others (for example payment or the provision of security) and was influenced by a desire to confer that advantage, then a preference is said to have occurred. If the preference occurred within stipulated time periods prior to insolvency proceedings, the office-holder can apply to the court to have it set aside.

---

[24] 50 Ed 3 c6 "*Fraudulent assurances of land or goods, to deceive creditors, shall be void*".
[25] *Belmont Park Investments Pty Ltd v BNY Corporate Trustee Services Ltd* [2012] 1 AC 383 (SC).

Similarly, transactions at an undervalue can be set aside on application to the court provided that they too occurred within a stipulated period. There is harsher treatment for transactions at an undervalue which are entered into for the specific purpose of defrauding creditors (a 'Paulian action').[26] In this case there is no need to prove contemporaneous insolvency and, instead of comparatively short hardening periods after which preferences and 'ordinary' transactions at an undervalue are immune from challenge, the only time constraints are the statutory limitation period of 12 years. In all these cases, there are protections for equity's darling, the bona fide purchaser for value without notice, provided the interest in question was not acquired from the company. Finally, under the heading of restorative transaction avoidance, there is also a rarely used power for an office-holder to challenge extortionate credit transactions.

All of the foregoing apply in liquidation and administration but not to voluntary arrangements. The last form of transaction avoidance only applies to liquidation and serves an entirely different purpose. A liquidator may, by notice, disclaim any unprofitable contract or unsaleable property – for example an onerous lease. The disclaimer ends the obligations of the company but only affects others to the extent necessary to achieve the release of the company. Anyone suffering loss as a result of the disclaimer can prove in the liquidation. The purpose of this power, which is essentially an administrative power, is to facilitate the closure of the estate and distributions to creditors.[27]

10 Cross-border Insolvency

It is now the case that a business of any size is likely to operate internationally. It remains a significant challenge that insolvency procedures in national laws are modelled to deal with companies in a group on an entity by entity basis which may bear little or no relation to the way in which they were organised and managed before insolvency. The World Bank, UNCITRAL and the EU are all examining possible solutions to the issues posed by groups of companies. In the meantime, much is achieved through protocols and court to court communications.

Even within the insolvency of a single company, there can be difficult issues. 'Cross-border insolvency' simply means insolvency with a foreign element. That could be because the debtor is a foreign company or because there are assets or creditors outside the jurisdiction.

---

[26] Actio Pauliana is civil law terminology for such claims, taking their name from the Roman law jurist Julius Paulus.

[27] *Hindcastle Ltd v Barbara Attenborough Associates Ltd* [1997] AC 70 (HL); *Re Park Air Services Plc* [2002] 2 AC 172 (HL).

The key issues which arise from the presence of a foreign element are jurisdiction, recognition and choice of law. By jurisdiction, we mean which court or courts will have jurisdiction to open insolvency proceedings in respect of the debtor. Recognition is the issue which arises as soon as an office-holder has occasion to take some steps in a jurisdiction other than that in which he was appointed. The issue is then whether, and if so to what extent, he will be recognised in that other jurisdiction as possessing any authority. Wherever appointed, the office-holder must first address which law applies to whatever he is doing. To take a simple example, an English liquidator could be presented with a proof of debt from a creditor claiming under a contract which states that it is governed by foreign law. In such case, the existence of liability is a matter of contract to be determined by the application of the governing law clause but the eligibility and ranking of that claim in the English liquidation will be a matter of English insolvency law. There are some rules dealing with all these issues but much remains uncharted water.

The position in respect of all these matters is clearest when dealing with companies that have their centre of main interests in an EU member state.[28] EC Regulation 1346/2000 provides that only the member state in which the 'COMI' is located can open 'main' proceedings although secondary proceedings are possible in any other member state where there is an establishment. Main proceedings apply to all the debtor company's assets and undertaking but secondary proceedings are only concerned with local assets. Proceedings opened in accordance with these jurisdictional rules benefit from automatic recognition throughout the EU and, with some exceptions, the law of the jurisdiction in which the proceedings have been opened governs all issues which arise in the course of those proceedings.

Where the EC Regulation does not apply, the approach of English law is markedly different. The English courts will wind-up a foreign company under their jurisdiction to wind up unregistered companies provided that the foreign company has a sufficient connection with England, those applying for the winding-up order will benefit from it and there are persons interested in the winding-up over whom the court can exercise jurisdiction. Foreign companies (other than those to which the EC Regulation applies) cannot be put into administration or a company voluntary arrangement unless either they are incorporated in an EEA state or the English court is under a duty to act in aid under section 426 of the Act (which is discussed below).

[28] Excluding, for these purposes, Denmark which exercised an opt-out from EC Regulation 1346/2000. An amended version, EU Regulation 2015/848, will replace the existing Regulation with effect from 26 June 2017.

Recognition of English insolvency proceedings in other jurisdictions is a matter for the laws of those jurisdictions unless the EC regulation applies. An international standard has been set by the UNCITRAL Model Law on Cross Border Insolvency which broadly adopts the concepts of main and secondary proceedings from the EC Regulation. A foreign office-holder can apply for recognition. Recognition of a foreign main proceeding results in automatic stay. Further discretionary relief is available for both main and secondary proceedings with can include turnover orders and assisting with information gathering. The UK enacted the Model Law in the form of the Cross-Border Insolvency Regulations 2006. The Model Law has been enacted by 21 other states including, most importantly, the United States where it forms Chapter 15 of the US Bankruptcy Code.

Section 426 of the Act is another important provision when considering the extent to which the English courts will act in aid of foreign proceedings. Section 426 applies to letters of request received from courts on the Channel Islands and the Isle of Man as well from the courts of certain other designated jurisdictions. The composition of that list reflects countries with which there were historical associations (principally now Commonwealth countries) and thus an expectation (by no means always fulfilled) of reciprocity. Where section 426 applies, the English court can apply either English law or the law of the requesting court to the subject matter of the request. An example of the section 426 jurisdiction was *Re HIH Casualty & General Insurance Ltd*[29] where the House of Lords ordered English provisional liquidators to hand over English reinsurance recoveries to the Australian liquidators of an Australian insurance company, so that they could be distributed to creditors in accordance with Australian distribution rules which differed from those under English law. However, it should be noted that neither the 2006 Regulations nor section 426 give the English courts jurisdiction to enforce foreign judgments as such.[30] This is a subject of some controversy where the English courts are perceived by some (but not the author) to be failing to act in accordance with the principle of universalism under which the ideal is that there should be one set of insolvency proceedings dealing, as far as possible, with all the assets of the debtor company and all its creditors.

Lastly there is common law assistance. In this respect, there was a restatement of the law by the Privy Council in *Singularis Holdings Ltd v PricewaterhouseCoopers*[31] where the issue was whether a Bermudian court could order an examination of auditors, on the application of Cayman Islands liquidators, in circumstances where there was no applicable provision under

[29] [2008] 1 WLR 852 (HL).
[30] *Rubin v Eurofinance SA* [2013] 1 AC 236 (SC).
[31] [2015] BCC 674 (SC).

Cayman law and the relevant Bermudian statute applied only to domestic proceedings. A majority of the Privy Council was prepared to hold that acting in aid pursuant to common law could extend to ordering examination but the panel was unanimous in deciding that the absence of any applicable power under Cayman law was a bar. The result is that common law assistance has two overriding limitations. First there must be power in the jurisdiction where the insolvency proceedings are taking place to do at home that which is proposed to be done abroad and, secondly, the foreign court being asked to act in aid must have the power to make the order sought. Even where both these hurdles can be overcome, *Singularis* demonstrates that the precise nature of the power to be exercised must be carefully considered. All this matters much more for English office-holders seeking relief in other common law jurisdictions (a not uncommon problem, given the widespread use of off-shore jurisdictions for financing structures) than in respect of in-bound requests for assistance. The combined effect of the EC Regulation and the 2006 Regulations means that the *Singularis* issues do not arise on in-bound cases.